

**California Debt and
Investment Advisory Commission**
“Introduction to Interest Rate Swaps”
Long Beach, California
April 20, 2007
Case Study
**The Metropolitan Water District
of Southern California**

Overview

- Overview of Metropolitan
- Outstanding Debt
- Interest Rate Swap Portfolio
- Why Metropolitan has used Swaps
- Evolution of the Swap Portfolio
- Negotiated and Competitive Transactions

Overview of Metropolitan



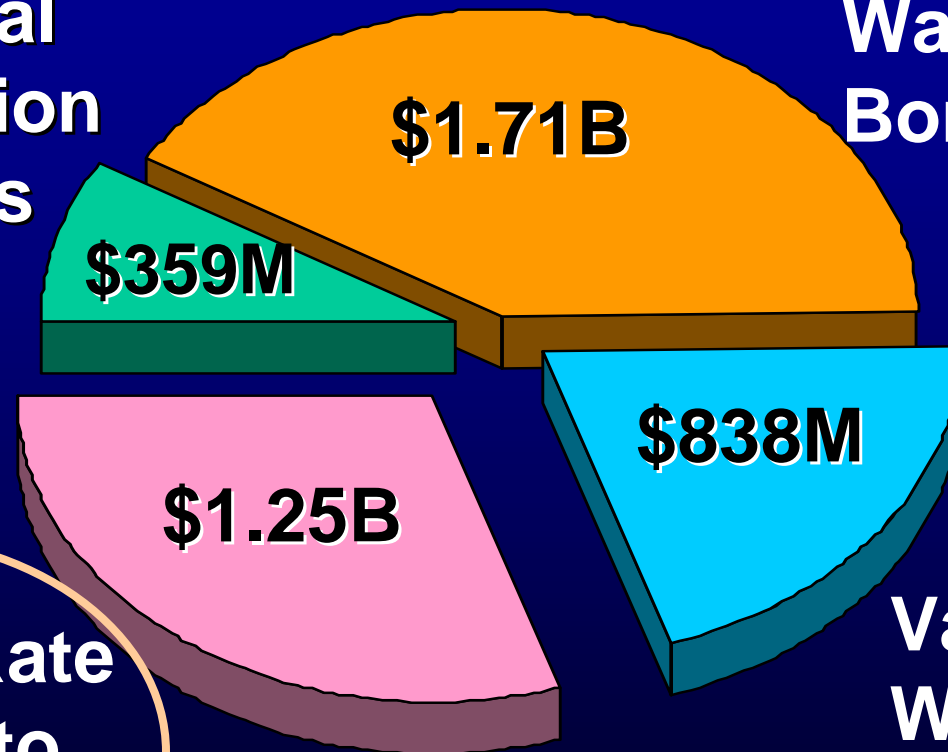
- AA+ / Aa2 / AA+
- Six counties: 5,200 square miles
- 18 million people
- Wholesale provider
- Import water from Colorado and Northern California
- Regional economy: \$887 billion
- Capital Program: \$2.0B next 5 years
- MWD provides 50% to 60% of water in Southern California

Total Debt Outstanding

\$4.16 Billion

General
Obligation
Bonds

Fixed Rate
Water Revenue
Bonds



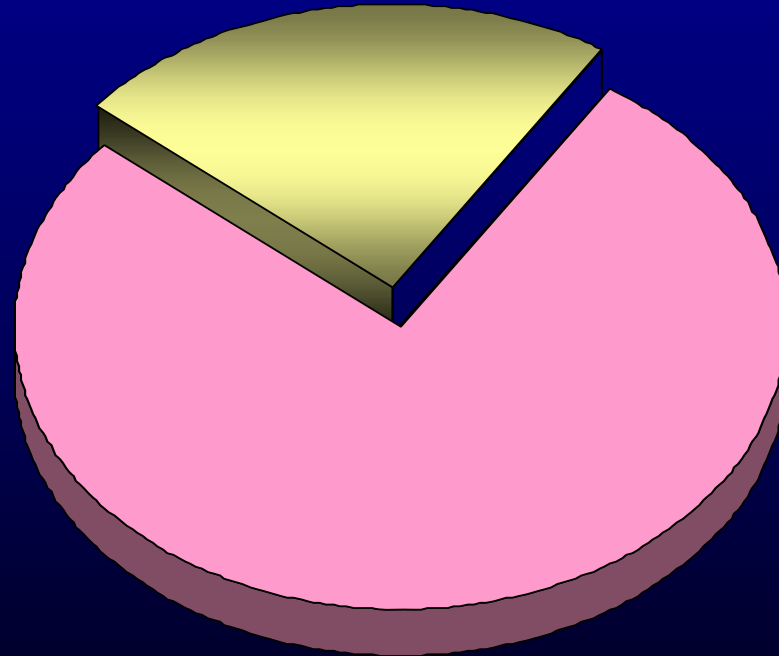
Variable Rate
Swapped to
Fixed Rate

Variable Rate
Water Revenue
Bonds

Interest Rate Swaps

\$1.63 Billion Notional

Basis Swaps: \$375 million



Payor Swaps: \$1.25 Billion

Why has Metropolitan Utilized Interest Rate Swaps?

- Lower costs than bond financing
- Increase variable rate debt without debt issuance or liquidity costs
- Flexibility to take advantage of favorable market conditions
 - access more efficient taxable market
 - preserve call option on existing bonds
- Financial tool to enhance asset - liability management

When / Why Use Swaps?

To lower costs

- **Bond refunding (with swap) to increase savings above refunding goals**
- **Issue variable rate bonds**
- **Enter into an interest rate swap to “convert” the payment to a fixed rate**
- **Swapped fixed rate is lower than the rate on a fixed rate bond**
- **Fixed payor swap (floating to fixed)**

Risks Associated with Interest Rate Swaps

- **Basis risk** - index reliance
- **Tax risk** - change in marginal tax rates
- **Counterparty risk**
- **Termination payments**

Evolution of Swap Portfolio

- Bonds
- BMA Swap
- LIBOR Swaps
- Basis Swaps
- ? ?

BMA Fixed Payor Swap

August 2001

Yield

6.00%

5.50%

5.00%

4.50%

4.00%

3.50%

3.00%

2.50%

2.00%

1

2

3

5

7

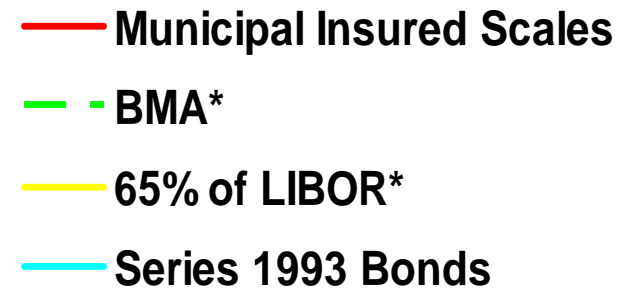
10

15

20

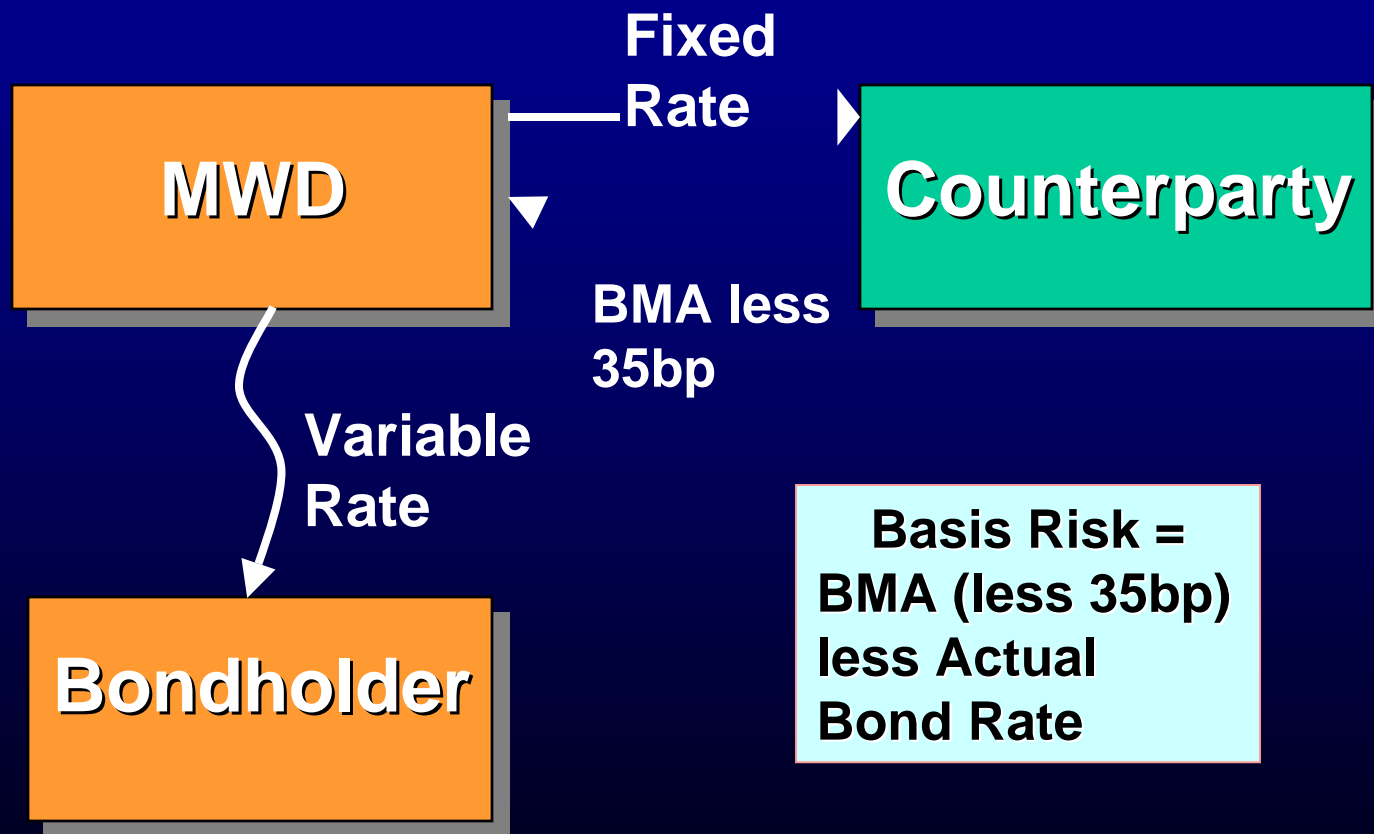
30

Maturity



BMA Fixed Payor Swap

August 2001



LIBOR Fixed Payor Swap

August 2002

Yield

6.00%

5.50%

5.00%

4.50%

4.00%

3.50%

3.00%

2.50%

2.00%

1.50%

1.00%

1

2

3

5

7

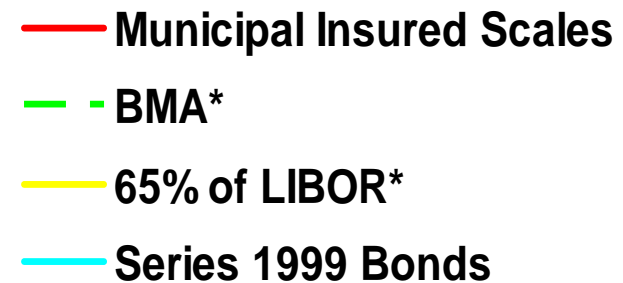
10

15

20

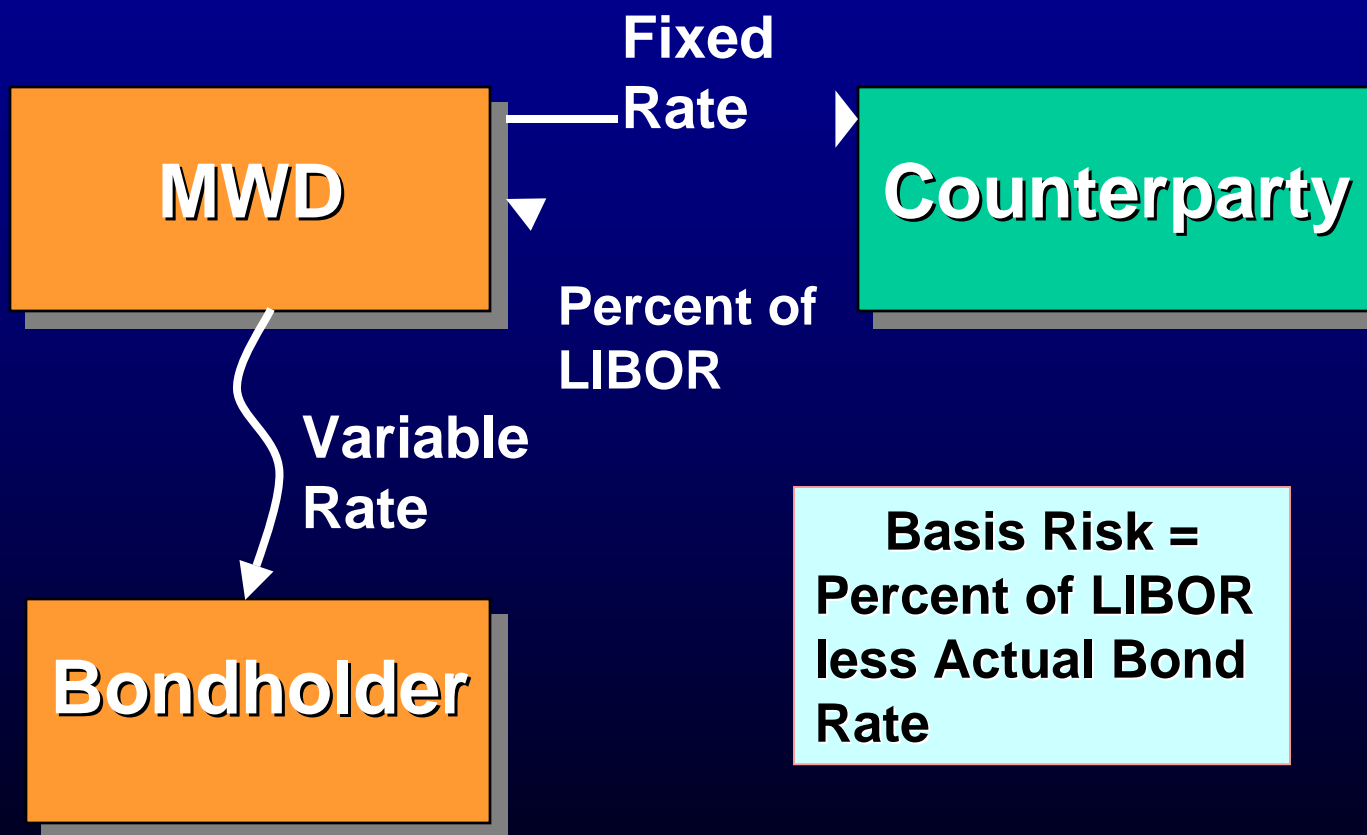
30

Maturity



LIBOR Fixed Payor Swap

August 2002



Basis Swap

May 2004

Yield

6.00%

5.50%

5.00%

4.50%

4.00%

3.50%

3.00%

2.50%

2.00%

1.50%

1.00%

1

2

3

5

7

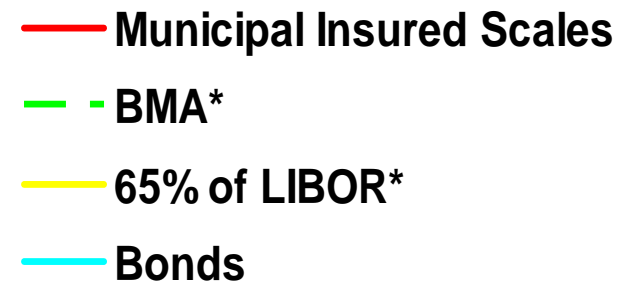
10

15

20

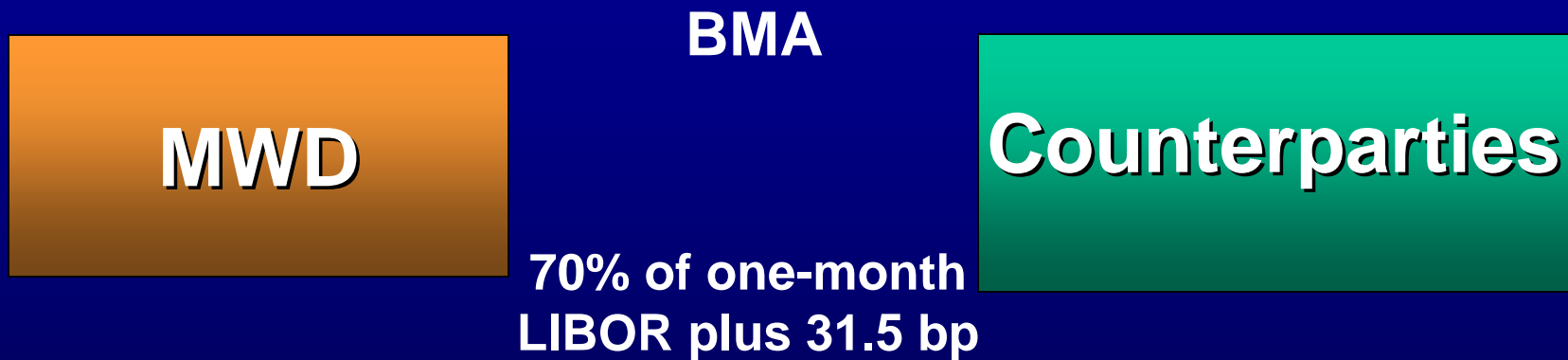
30

Maturity



2004 Basis Swap Trade

Notional \$250 million



Negotiated vs. Competitive

- **Competitive transactions:**
 - Results in best price ?
 - Swap terms must be clear
 - Bidding platform must be fair
 - Assurance of market price
 - Could create disruption in market

Negotiated vs. Competitive

- **Negotiated transactions:**
 - More flexible, better timing
 - Structure tailored to fit risk profile
 - Long term counterparty commitment
 - Competition for a negotiated deal
 - Achieve financial goals and ensure fair market pricing
 - Verification by swap advisor
- **Recognize that “close” can mean tens of thousands of dollars**

Execution Approach

Conclusions and Observations

- **Buyer beware: education is critical**
- **Timely and consistent disclosure is important**
- **Diversify among counterparties**
- **Spreads will continue to tighten**
- **Competitive and negotiated transactions can both work**
- **Know your market: swap advisors are necessary and helpful players**

Summary

- Understand the swap market
- Understand the benefits as well as the risks with interest rate swaps
- Establish a swap policy
- Utilize interest rate swaps in accordance with established policies and financial goals and targets

www.mwdh2o.com

